

# PUNITIVE DAMAGES AND ENTERPRISE LIABILITY

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## I.

Punitive damage awards have increased dramatically in recent years. My study of civil trial judgments in the courts of Cook County, Illinois (the Chicago metropolitan area) shows that the number of punitive damage judgments in the years 1978 and 1979 (the most recent years of the sample) were greater than that of any year since 1959 (the first year of the sample). Indeed, punitive damage awards in these years were, respectively, four and two and one-half times as large as the average annual number of punitive damage judgments from 1959 to 1979.<sup>1</sup> Punitive damages have been awarded in Cook County now in virtually all areas of civil liability, from street hazard and road construction cases to product liability, malpractice, and landlord-tenant cases. Since the late 1960's, there has occurred a steady increase in the number of punitive damage judgments in business tort and—unusually enough—contract breach cases. Of course, this increase in jury awards comprises only some very small fraction of the total sums paid out to parties claiming punitive damages.<sup>2</sup>

Professor Ellis's excellent treatment of punitive damages<sup>3</sup> demonstrates that there are no available theoretical justifications for these de-

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1. In 1978 and 1979, juries awarded punitive damages, respectively, in 26 and 15 cases. The average number of annual punitive damage judgments between 1959 and 1979 was 6.1, although 4 judgments or less were awarded in 10 of the 21 years and 3 or less each year between 1959 and 1966. These numbers are so small that I regard the changes as no more than suggestive. Statistical significance would be misleading.

2. Typically, less than 5% of claims are litigated to a verdict. H. ROSS, *SETTLED OUT OF COURT* 136 (1970). Because they involve amounts greater than the average, punitive damage claims are likely to be litigated more frequently. *Id.* at 216-17.

3. Ellis, *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1 (1982).

velopments. No new theories of justice have been discovered to generate more frequent punitive awards. Nor has economic theory developed new reasons. The narrow economic justifications for punitive damages are now commonplace.<sup>4</sup> Moreover, there are no reasons to believe either that the level of malice or the magnitude of losses from intentional or reckless behavior has increased in recent years.<sup>5</sup> How, then, can we explain the great increase in punitive damage awards?<sup>6</sup>

Let me offer as a hypothesis that the increase in punitive damage judgments is related to the theory of enterprise liability. The theory of enterprise liability provides in its most simple form that corporate enterprise ought to be responsible for injuries caused by products that it places in commerce or for losses suffered from the pursuit of its commercial interests. The acceptance of enterprise liability theory, in my view, is responsible for the general increase over the past two decades in the liability of manufacturers for product related losses, for example, the adoption of the standard of strict liability for product defects and increasing restrictions on the defenses available to manufacturers.<sup>7</sup> Acceptance of the theory, furthermore, may explain the large rise during the same period in the number of private antitrust actions and in their rate of success.<sup>8</sup> A relationship between enterprise liability theory and the increase in punitive damage judgments is not immediately implausible. My study shows an increase in punitive damage judgments in trial courts in actions involving harms attributed to business practices;<sup>9</sup> the Ellis paper is strewn with citations to extraordinary punitive judgments in favor of consumers against manufacturers, small dealers against large.

Nevertheless, the relationship between enterprise liability theory

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4. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 142-43 (2d ed. 1977).

5. In 1978, Chicago jurors awarded punitive damages in 5 assault cases. In 1977 and 1979, however, the number of awards equalled the annual average for the 21 years: 1.

6. Not even scholars possessing the imaginative power to explain every development in the law as efficient can tell us why the number of punitive damage awards has increased. See Landes & Posner, *An Economic Theory of Intentional Torts*, 1 INT'L REV. OF L. & ECON. 127, 135-39 (1981) (proposing that punitive damages be awarded only for intentional torts involving deliberate wrongdoing or recklessness, but failing to explain the current increase in the number of punitive damage awards).

7. I discuss the intellectual history of enterprise liability in some more detail, *infra* text accompanying notes 14-34. See Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1299-1302 (1981); G. Priest, *Sindell: Its Origin and its Future* (1982) (unpublished manuscript on file with the *Southern California Law Review*) [hereinafter cited as Sindell].

8. See W. BAXTER, *THE POLITICAL ECONOMY OF ANTITRUST* 23-24 (R. Tollison ed. 1980) (numerical data on the disposition of private antitrust cases).

9. These include, among others, contract interference, fraud, and contract breach (involving insurance contracts, personal service contracts, the sale of property, and even debt).

and punitive damages is not entirely clear. Although many legal scholars have encouraged the extension of enterprise liability,<sup>10</sup> none, to my acquaintance, has specifically addressed punitive awards. The literature has focused on the assignment of liability to manufacturers and other corporate enterprise. Once manufacturers are held liable, compensatory damages generally have been regarded as sufficient.<sup>11</sup> What further purpose would be served by punitive awards?<sup>12</sup>

One central assumption of enterprise liability theory, if taken seriously, can justify punitive awards. Indeed, the assumption justifies the unlimited extension of liability to corporate enterprise. Although some scholars over the years have criticized aspects of enterprise liability theory,<sup>13</sup> this central assumption of the theory has remained unchallenged. Professor Ellis' study builds upon the same empirical assumption and is similarly incomplete. As a consequence, Ellis', as well as most other legal and economic studies of enterprise liability, have inadequately informed courts about the implications of extending liability, including the implications of increasing the availability of punitive damage awards.

## II.

The empirical assumption accepted by Professor Ellis, by most legal and economic students of enterprise liability, and by the courts is that consumers have no role to play in the avoidance of injuries from product use or other corporate activity.<sup>14</sup> The level of safety (or, say, of contract breach) is determined solely by investments of the corporate entity, whether manufacturer or insurer. There is a distinguished history of support for this assumption. It was a major project in the 1940's

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10. *E.g.*, James, *General Products: Should Manufacturers be Liable Without Negligence?*, 24 TENN. L. REV. 923 (1957) (arguing that strict liability is preferred over a system of liability based on fault whenever there is an enterprise or activity, beneficial to many, that takes an inevitable accident toll of human life).

11. Compensatory damages will encourage tortfeasors to prevent injuries when the costs of prevention are less than the expected losses.

12. I ignore in this Comment arguments that punitive damages ought to compensate for the victim's litigation costs, discussed in Ellis, *supra* note 3, at 10-12. It is unlikely that the changes over time in punitive damage awards are closely correlated with changes in the level of attorneys' fees.

13. R. EPSTEIN, *MODERN PRODUCTS LIABILITY LAW* 190-93 (1980) (allocation of loss based on shared expectations and liability imposed only for latent defects in a product which cause injury in ordinary use; assumption of the risk and contributory negligence defenses should be allowed).

14. With respect to products liability, other related assumptions are that manufacturers or other enterprises do not compete over product safety, but act to minimize obligations for losses. Sindell, *supra* note 7, at 4. The assumption that consumers play no role in preventing injuries, however, is sufficient to justify punitive damages. See *infra* text accompanying notes 36-43.

and 1950's of lawyers urging the adoption of principles of enterprise liability in the products field to convince the public, the academy, and the courts that there was nothing that a consumer could do to prevent product injuries. Professors James and Dickinson showed (asserted) that consumer fear of injury was sufficient to elicit maximum consumer investments in safety.<sup>15</sup> Professor James, citing unnamed "studies of human behavior," showed (asserted) that accident prevention by individuals was insignificant in comparison to prevention by "institutions and organized groups."<sup>16</sup> Professor Kessler showed (asserted) that product consumers and insureds were powerless in comparison to manufacturers or insurers and that the terms of product warranties and of insurance contracts were unaffected by competitive pressures or consumer preferences.<sup>17</sup>

The courts accepted these empirical characterizations<sup>18</sup> and the policy recommendations that followed from them. Most legal and economic scholars accepted the characterizations as well. My colleague, Guido Calabresi, in his very influential book, *The Costs of Accidents*, published in 1970, defined an analytical framework incorporating the possibility of consumer investments in safety.<sup>19</sup> But, to demonstrate his approach, Calabresi consistently presents examples in which the method of reducing the accident rate is some technological investment alone (which the manufacturer is surely in a better position to provide).<sup>20</sup> In *The Costs of Accidents*, the role of accident law in spreading

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15. James & Dickinson, *Accident Proneness and Accident Law*, 63 HARV. L. REV. 769, 780 (1950).

16. James, *supra* note 10, at 923.

17. Kessler, *Contracts of Adhesion—Some Thoughts about Freedom of Contract*, 43 COLUM. L. REV. 629, 636-37 (1943); Kessler, *Forces Shaping the Insurance Contract*, 374 INS. L.J. 151, 152 (1954). Kessler's theory and its influence is discussed in more detail in Priest, *supra* note 7, at 1299-1302.

18. *E.g.*, *Vandermark v. Ford Motor Co.*, 61 Cal. 2d 256, 260-64, 391 P.2d 168, 170-72, 37 Cal. Rptr. 896, 898-900 (1964); *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 377-84, 161 A.2d 69, 79-84 (1960).

19. G. CALABRESI, *THE COSTS OF ACCIDENTS* (1970). Calabresi accepts and endorses a policy of enterprise liability. *Id.* at 53-54, 84, 162-65, 245, 252, 261. Nevertheless, the book's analysis is sufficiently general to incorporate other policies.

20. *Id.* at 73-75 ("new-style" brakes), 137-38 (hardness of bumpers), 139 (hardness of bumpers), 156 (type of brakes), 259 (hardness of bumpers). In virtually all other examples, Calabresi pictures the assignment of liability not as leading to greater care by consumers, drivers, or pedestrians, but as influencing only the levels of activity of these groups. Thus, assigning liability to teenage drivers or pedestrians will not lead to more careful driving or walking, but only to less driving and walking. *Id.* at 73, 139, 145, 148, 153-54, 156, 177, 182, 195, 213 (2 examples), 217-18, 276. In the entire book, the only examples given suggesting that victims might be in a better position than injurers to take specific precautions to avoid losses are where the victim knows that he is particularly sensitive to injury, such as suffering an allergy, *id.* at 163, or where the victim places a particularly high personal value on some aspect of the loss. *Id.* at 223. The single empiri-

losses dominates—and, according to Calabresi, ought to dominate—its role in reducing the accident rate.<sup>21</sup> Of course, accident law can successfully spread losses only if manufacturers and other enterprises (who are able to add an insurance premium to the price of the product) are generally liable for losses.

Acceptance of the assumption that consumers cannot take precautions is not always explicit. Yet, even Professor Posner's discussion of products liability in *Economic Analysis of Law* presumes no important investments by consumers in reducing accidents (although oddly it considers seriously that consumers may be risk preferrers) and emphasizes the extent to which consumers are uninformed about product risks.<sup>22</sup> Today, technical papers discussing aspects of enterprise liability routinely regard consumer investments in safety as unimportant or of subsidiary importance. It is commonplace to observe footnotes explaining that the analysis "abstracts from moral hazard."<sup>23</sup> More complete articles typically discuss first accidents whose occurrence is affected only by injurers, relegating to subordinate sections accidents whose occurrence is affected by both injurers and victims.<sup>24</sup>

The implications of enterprise liability where consumers make no investments in safety are straightforward and now well-known. The most common, but mistakenly simplistic, conclusion is that safer products will result.<sup>25</sup> According to this view, manufacturers invest in product safety in order to avoid liability; thus, the greater the liability, the

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cal datum presented in the book, upon which the book's theory heavily relies, is the claim that the number of workplace safety precautions was substantially increased after liability for workplace injuries was shifted from employees to employers by workmen's compensation acts. *Id.* at 245. Calabresi presents neither data nor a reference to data supporting this claim.

21. *E.g., id.* at 37, 64, 92, 96, 164. Calabresi consistently conflates risk distribution with income redistribution. *Id.* at 47-48, 50, 55, 63, 92. Curiously, Calabresi's insistence on income redistribution as a goal of accident law derives from his acceptance of enterprise liability as a social mandate. Calabresi reasons that since the society has accepted enterprise liability, the liability system must be employed to redistribute income. *Id.* at 52-55, 164. Thus, the failure of the fault system to redistribute income becomes, in Calabresi's terms, a "secondary cost" of accidents. *Id.* at 39-64.

22. R. POSNER, *supra* note 4, at 135-37.

23. *E.g.,* Spence, *Consumer Misperceptions, Product Failure and Producer Liability*, 44 REV. ECON. STUD. 561, 566, 572 n.5 (1977). But see Oi, *The Economics of Product Safety*, 4 BELL J. ECON. 3, 8-19, 25 nn.41 & 44 (1973) (consumer investments treated as significant).

24. For recent examples, see Polinsky, *Strict Liability v. Negligence in a Market Setting*, 70 AM. ECON. REV. 363, 363 & n.3, 367 (1980); Shavell, *Strict Liability versus Negligence*, 9 J. LEGAL STUD. 1, 1, 6-9, 17-22 (1980). This sequence has more than expositional importance. It confers significance upon the example of the unilateral, corner-solution in a context (where the effect studied is the rate of activity) in which there exist no unilateral, only bilateral, cases.

25. *E.g.,* Prosser, *The Fall of the Citadel (Strict Liability to the Consumer)*, 50 MINN. L. REV. 791, 799 (1966).

greater will be the investment in safety. This view must concede that, relative to a freely negotiated standard of liability,<sup>26</sup> the product will be "too safe" given consumer preferences.<sup>27</sup> Its price will be higher and its sales lower. Nonetheless, the product will be safer.

More careful analyses of the problem have shown that these implications are not correct. Where a manufacturer and a consumer have negotiated<sup>28</sup> for some level of manufacturer investment in safety, that level will be optimal and will not be influenced by the legal standard of liability.<sup>29</sup> However, support has been found on other grounds for the expansion of liability. Following Professor Posner, it is commonly presumed that legal rules are defined to achieve efficiency.<sup>30</sup> Thus, various prominent theorists assume that the law has carefully defined those actions that it regards as negligent or contributorily negligent in ways that optimize costs and benefits.<sup>31</sup> When it is assumed that standards of care are set at efficient levels, it has been shown (and it is the conventional wisdom) that either a negligence or a strict liability regime is efficient.<sup>32</sup> Strict liability is preferable, however, if neither consumer investments in preventing injuries nor the extent to which the consumer uses the product is affected by the legal standard, because manufacturers will then take the level of activity into account.<sup>33</sup> Strict liability may be even more strongly endorsed if consumers underestimate risks, because without the standard consumers will purchase products too dangerous for their own good.<sup>34</sup>

These models reinforce the enterprise liability approach in two subtle ways. First, the initial assumption that negligence and contributory negligence are defined efficiently is only plausible where there is

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26. Consumers may "negotiate" with manufacturers over the level of product safety by exercising preferences for product design and quality or for warranty protection. For a description of these processes, see Priest, *supra* note 7, at 1346-47. For evidence of their effect, see *id.* at 1328-46.

27. Professor Posner derives this result, but does so from his assumption that consumers are risk preferrers. R. POSNER, *supra* note 4, at 136-37.

28. See *supra* note 26.

29. That is, the manufacturer will invest in safety until the cost of such investment equals the benefit in reduction of consumer losses. Beyond this point it will cost the manufacturer less to pay damages than to make the product even safer. A change in liability that yet allows a contractual reassignment will not change either the cost of safety investment or the frequency of consumer losses and so will not change the manufacturer's incentive to invest. See R. POSNER, *supra* note 4, at 135-36, 137-38; Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 2-10 (1960) (if market transactions are costless, a change in liability will not affect resource allocation).

30. R. POSNER, *supra* note 4, at 15-192.

31. See, e.g., Shavell, *supra* note 24, at 22-25; Polinsky, *supra* note 24, at 363.

32. Shavell, *supra* note 24, at 3-4; Polinsky, *supra* note 24, at 363.

33. Shavell, *supra* note 24, at 3; Polinsky, *supra* note 24, at 366.

34. Spence, *supra* note 23, at 561; Shavell, *supra* note 24, at 4; Polinsky, *supra* note 24, at 366.

some link between the legal order and efficiency. This assumption suggests—although the conclusion is never explicitly stated—that the universal adoption of the strict liability standard itself is efficient. As mentioned earlier,<sup>35</sup> the adoption of the strict liability standard can only be efficient when it does not influence the level of consumer investments in safety, most clearly when consumers make no relevant investments in safety. Second, because these models regard consumers as always behaving optimally, consumer investments in safety are irrelevant to the issue of liability. The comparison of strict liability and negligence regimes proceeds as if consumers have no influence on the production of safety over the margin relevant to liability.<sup>36</sup>

Professor Ellis' discussion of the effects of punitive damage liability, while acknowledging the theoretical refinements, recalls the earlier and simpler results. When punitive damages are assessed, a manufacturer may invest in safety beyond the point at which the cost of such investment equals the benefit in the reduction of consumer losses.<sup>37</sup> Thus, Professor Ellis' description of the effects of increasing punitive damage awards shows that the number of harmful acts and of small, fuel-efficient cars will decrease:<sup>38</sup> "more resources will be consumed in automobile manufacturing";<sup>39</sup> these cars will, indeed, be safer;<sup>40</sup> but prices will be higher, and "revenues to manufacturers will be lower . . . as a consequence, aggregate welfare will be reduced."<sup>41</sup> Similar effects can be predicted for all those "engaged in activities where punitive damages are assessed . . ."<sup>42</sup> Uncertainty over the criteria and measure of punitive damages exacerbates the effect.<sup>43</sup>

It should not be forgotten that Professor Ellis predicts welfare losses from the expansion of liability. However, it requires a very clear appreciation of the concept of "welfare" in economics—a devotion to the welfare triangle approaching the religious—to convert the abstract conception of welfare into an imperative of social policy. It is understandable that, given these implications, courts have expanded rather than restricted enterprise liability. Why should not cars or other prod-

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35. *Supra* text accompanying notes 32-33.

36. I am indebted to A. Mitchell Polinsky for emphasizing this point.

37. A manufacturer will find it advantageous to invest in this manner universally under a strict liability standard or under a negligence standard where there is error in the determination of negligence. Ellis, *supra* note 3, at 47-48.

38. *Id.* at 49.

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at 50.

43. *Id.*

ucts be safer? Certainly the Pinto victims would have preferred safer cars. Indeed, surely current owners of Pintos would prefer their cars to be safer and wish that they had been less cost-conscious at the time of purchase. Should it be the role of the judiciary to protect these consumers willing to accept the risk of incineration? It would require an extraordinarily firm commitment to the principles of individual liberty and autonomy to deny liability or the recovery of punitive damages in such cases. Indeed, if the principal consequence of expanding liability and multiplying damages is safer products, why should the trend be stopped?

Of course, it is possible as an empirical matter that, in each of the varied circumstances in which enterprise liability has been expanded or punitive damages awarded, consumers make no investments to reduce losses. Since the announcement of the Coase theorem, however, it has been more typical to consider liability questions as reciprocal in nature; to regard the effective margin for the choice of a liability rule as involving investments of both affected parties which are complementary over some range but are substitutes at the liability margin.<sup>44</sup> Thus, Figure I describes the production of safety or accident avoidance as a function of joint factors, investments by a manufacturer, M, and by a consumer, C. Familiarly,<sup>45</sup> the optimum allocation of investments between manufacturer and consumer is that point tangent to the highest output isoquant,  $S_0$ , at which the investment by the manufacturer is  $M_0$  and by the consumer is  $C_0$ . A liability or damage rule that encourages greater investment by the manufacturer, say  $M_1$ ,<sup>46</sup> will lead to a lower optimal investment by the consumer,  $C_1$ .<sup>47</sup> Welfare will be reduced. More importantly, however, the production of safety will fall from output isoquant  $S_0$  to output isoquant  $S_1$ .<sup>48</sup>

44. See Coase, *supra* note 29, at 2, 12-13 (both parties may be said to "cause" an accident).

45. See generally J. HIRSHLEIFER, PRICE THEORY AND APPLICATIONS 278-88 (2d ed. 1980) (at any given budget, the highest obtainable output occurs where the iso-cost line is tangent to an output isoquant). For an application of this analytical technique to liability rules, see Brown, *Toward an Economic Theory of Liability*, 2 J. LEGAL STUD. 323, 324-27 (1973).

46. A change in the liability rule may lead to greater investment by the manufacturer and lower investment by the consumer if it (1) requires the introduction of a specific device or investment; (2) imposes greater than compensatory damages (such as punitive damages); or (3) reduces the standard of care required of consumers. Of course, contributory negligence is likely to be defined quite differently under negligence and strict liability regimes.

47. Thus, the relative prices of M and C (indicated by the slope of MC) remain constant. To simplify matters, long term effects on input prices are ignored.

48. For expositional convenience, the Figure describes total investment in product safety relative to other product characteristics as fixed (at the distance of MC from the origin). The result that the level of safety produced by the sum of manufacturer and consumer investments will



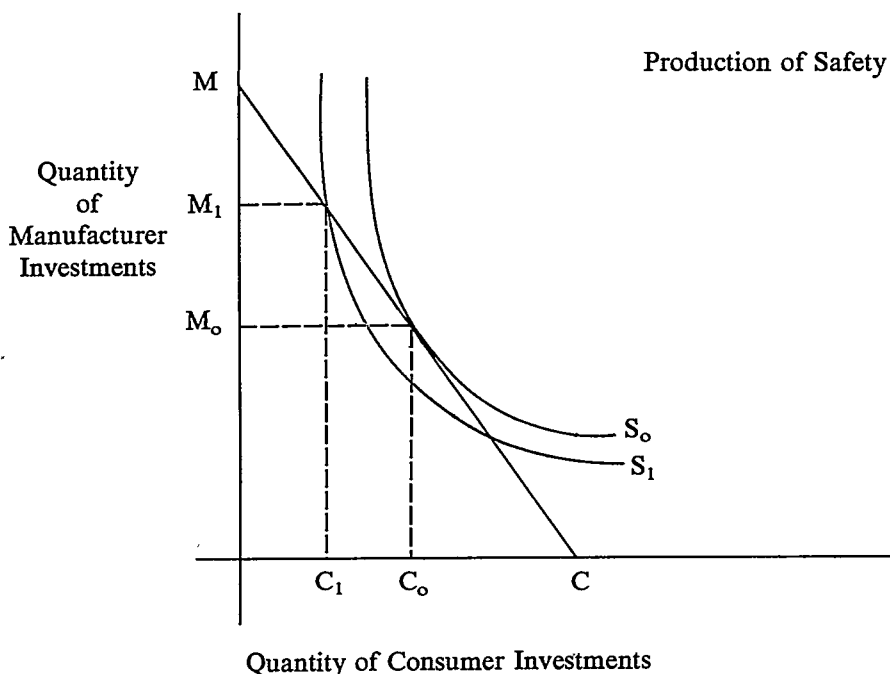


Figure I

It is this implication that is ignored in the analyses of enterprise liability. If manufacturer and consumer investments are substitute factors in the production of safety or accident avoidance, then increasing the liability of manufacturers will lead to a *decrease*, not an increase, in safety. Cars will be "safer" in some mechanical sense. Manufacturers will invest more in automobile safety, but the total output of safety or accident avoidance will decline. There will result not too much safety, but too little safety, because rational consumers will diminish their investments in safety and the joint product will decline.

At  $M_1C_1$ , the manufacturer has increased its investment in safety, and the consumer, because he optimizes costs and benefits, has decreased his investment in safety. At  $M_0C_0$ , however, the marginal products of manufacturer and consumer investments were proportional to their prices, while at  $M_1C_1$ , they are not. Thus, although at the new position the manufacturer's investment has increased, the total output of safety has fallen because of the influence of the decline in the marginal product of the consumer's investment. The analyses of enterprise liability and punitive damages, in contrast, by assuming that consumer

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decline, however, is quite general as long as manufacturer investments are a sufficiently good substitute for consumer investments.

investments in safety are unimportant, present the safety production decision as a corner solution, M. Thus, the only effect of expanding enterprise liability is to shift point M upwards and to make products safer.

The implication that the expansion of enterprise liability reduces safety is not an analytic result. The extent to which consumer investments are significant at the accident margin, and whether or not the legal standards influencing consumer investments are efficiently defined remain empirical questions.<sup>49</sup> Thus, I know of no modern analyst of enterprise liability who is clearly mistaken. Nevertheless, the absence of any discussion of these effects in the great majority of analyses of enterprise liability is noteworthy. It is very hard to believe that consumer investments are irrelevant in *every* area to which enterprise liability has been extended. Consumer investments, of course, are more subtle than manufacturer investments and are much more difficult to identify and measure. However, the few empirical studies that have considered consumer investments with any care—Peltzman's study of automobile safety regulation<sup>50</sup> and my study of consumer product warranties<sup>51</sup>—have shown consumer investments to be significant determinants of accident avoidance.

### III.

It is speculation to link an intellectual movement as apparently broad and deep as is enterprise liability to the acceptance of an empirical assumption that I guess to be wrong. It is peculiar, however, for economists to concur almost universally that safety, as opposed to most other products at the liability margin, is a unitary rather than a joint product. The purpose of papers such as that of Professor Ellis must be to persuade its readers (most importantly, the courts). Professor Ellis demonstrates convincingly the absence of theoretical justification for punitive damage judgments. But the success of the theory of enterprise liability has derived from persuasion of a different sort: the insinuation of certain empirical "truths."

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49. I discuss in more detail evidence of the determinants of accident avoidance and the concept of the "accident margin" in G. Priest, *The Best Evidence of the Effect of Product Liability Law on the Accident Rate* (unpublished manuscript forthcoming in 91 YALE L.J.).

50. Peltzman, *The Effects of Automobile Safety Regulation*, 83 J. POL. ECON. 677, 682-83, 721-24 (1975).

51. Priest, *supra* note 7.